Moscow Financial Weekly

For the Weeks Ending August 31, 2001

Treasury Attache's office, US Embassy Moscow

Highlights This Week

- Cyprus becomes #1 in FDI.
- August Inflation is zero.
- **Weekly Focus**: **The 2002 Budget**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	29.4063	0.11	4.41
Monetary Base*	R628.7 bln	-0.62	30.25
CPI	NA	N/A	13.2
International Reserves*	$37.0 bln	-1.60	30.74
RTS Index (end of week)	205.41	-0.06	44.36
Refinancing rate	25	0	0

*For week prior

Economic Developments

During the first half of 2001, Cyprus officially became the #1source of foreign direct investment into Russia with 17% of the total, mostly to the fuel and energy sector. The USA was second with12.3%, with a significant portion going to machine-building and metallurgy. Meanwhile, Russian outflows of capital have dropped $1.2 billion during the first half of the year (y-o-y) to $6.5 billion, according to Goskomstat. Only a tiny portion - $220 million - was direct foreign investment with rest primarily run –of the mill capital flight (ie bank deposits) and trade credits. $4.8 billion of this outflow ended up in the States.

These two items are a strong sign that Russia is beginning to turn the corner on a decade of capital flight and that the investment environment is truly improving. While the direct investment numbers can be influenced by one or two big deals, there is anecdotal evidence that the primary producers are bringing their hard currency earnings back to diversify into downstream businesses. That Cyprus, Russia's principal offshore zone, has now become the biggest foreign investor is a positive sign – Russians are in a better position to judge Russia's investment environment than truly foreign investors and Russian offshore money coming back should act as signal for other investors.

Banking sector

According to the CBR, in H1 2001 ruble lending by Russian banks (business and personal) totaled R3,890 billion, double the H1 2000 level. Foreign currency loans were R2372 billion, a 26.8% increase. Because ruble lending grew at a faster pace than foreign currency lending, the share of ruble loans rose from 51.01% to 62.88%. This dynamic is viewed by some as evidence of "dedollarization".

But on the deposit side the picture is just the opposite: foreign currency deposits grew at a faster pace than ruble deposits. Ruble deposits grew by R428.2 billion though July 1,2001, 40.8% more than a year earlier. Foreign currency deposits meanwhile grew R413.4 billion, an increase of 55.2%. The share of ruble deposits fell from 53.3% as of July 1, 2000 to 50.9% as of July 1 2001. The higher dollar deposit rates reflect higher net imports of cash foreign currency in H1 2001, $4.45 billion vs. $3.0 billion in H1 2000. This suggests that far from dedollarization, businesses want to hold ready cash in hard currency, a sign they don't trust the stability of the ruble.

Bank of Moscow has completed its 7-th share issue worth R1.4 billion. As a result its authorized capital nearly doubled R3 billion, while net worth exceeds R5 billion. The Moscow City government retained its share of 62.7%. The issuance was needed to keep its capital adequacy ratio above the required minimum. The bank is now the 8-th largest by capital.

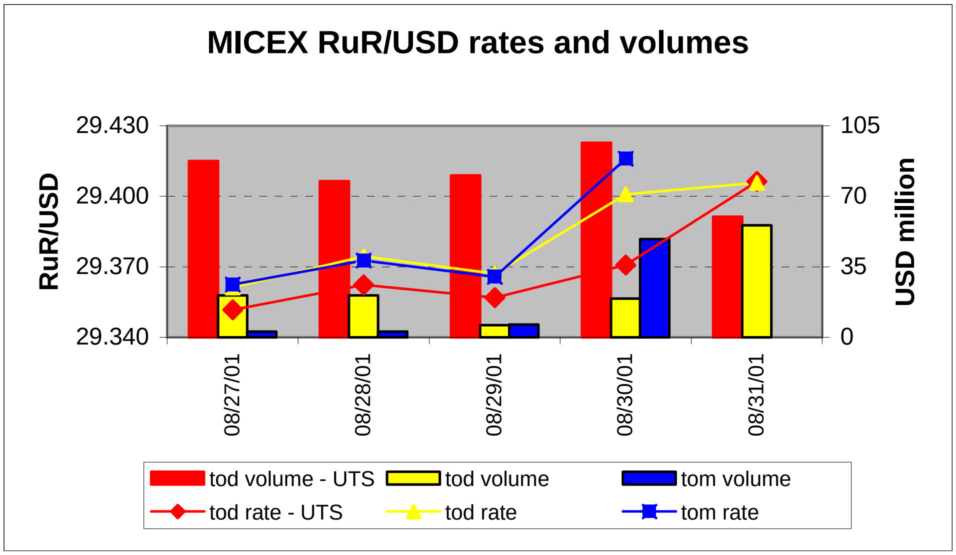
MDM Bank confirmed that it bought a controlling stake in Expobank. Moscow-based Expobank is among 100 largest Russia's banks.

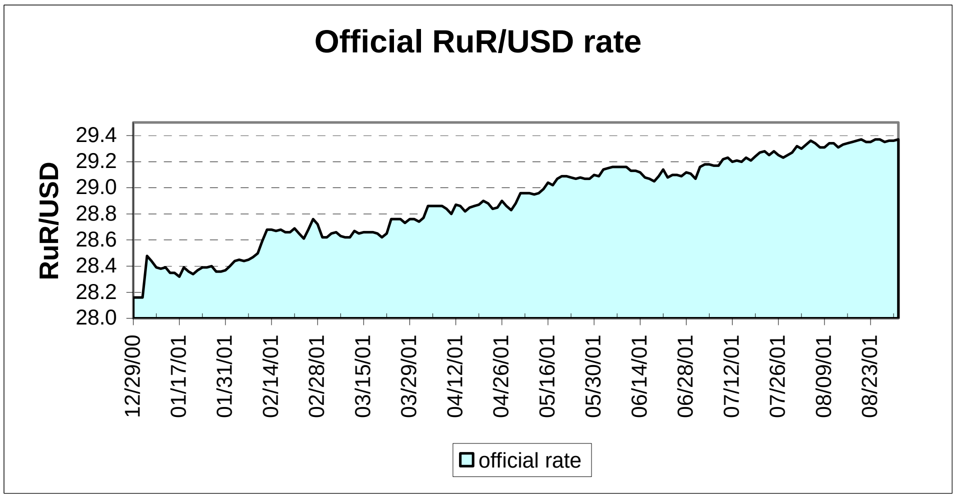
Financial markets

Forex Market

The currency market was calm in the first half of the week as banks reduced the demand for dollars in anticipation of end-of-month ruble payments. On Wednesday, balances on correspondent accounts unexpectedly began to rise and Thursday's CBR announcement that reserves fell by $600 million sent the ruble tumbling below R29.4/$. (This is somewhat odd since the drop was expected because of Russia's large Paris Club payment.) On the last day of the month balances on correspondent accounts increased by another 10.6% and volume for the day reached above $1 billion. The CBR sold at least $300 million.

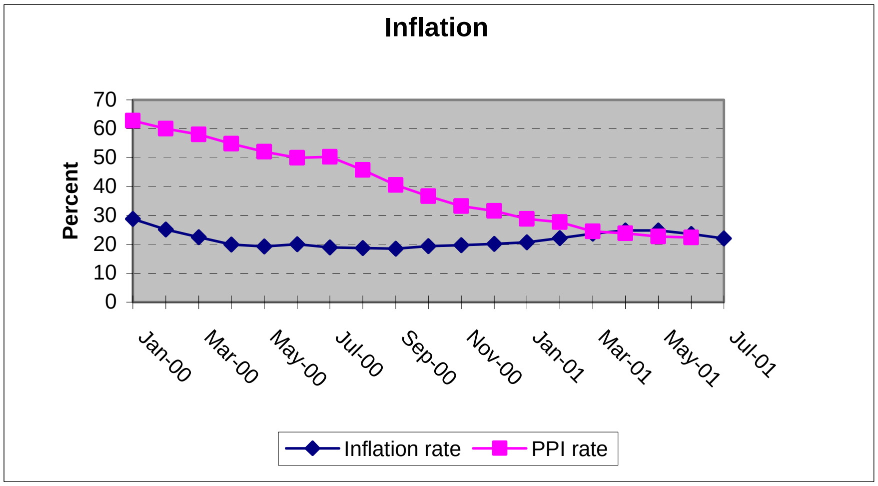
For the whole week the ruble weakened 0.11%, closing in the UTS on Friday at 29.4063/$. MICEX weekly trade volumes were $401,93 million, $121.77 million and $70,59 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.

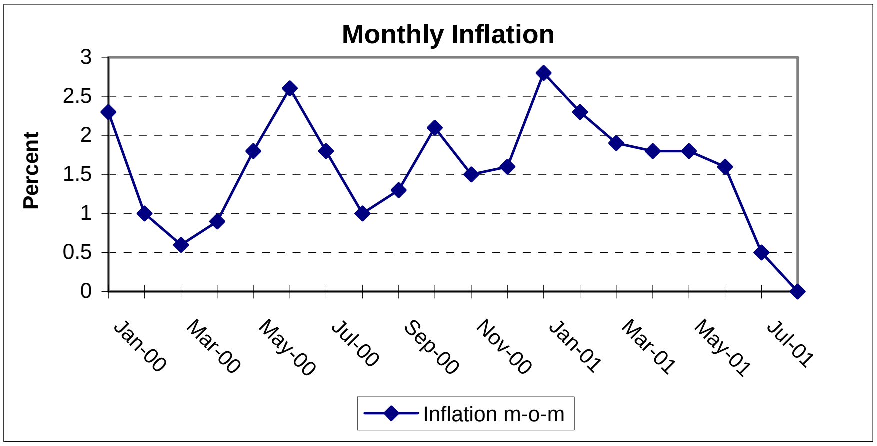




<u>Prices</u>

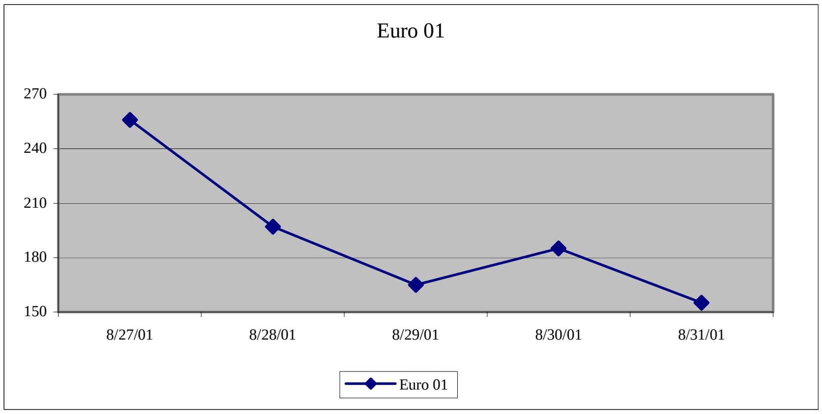
Inflation in August was zero. Excluding fruit and vegetable prices, which traditionally fall in August, prices grew by 1.1%.

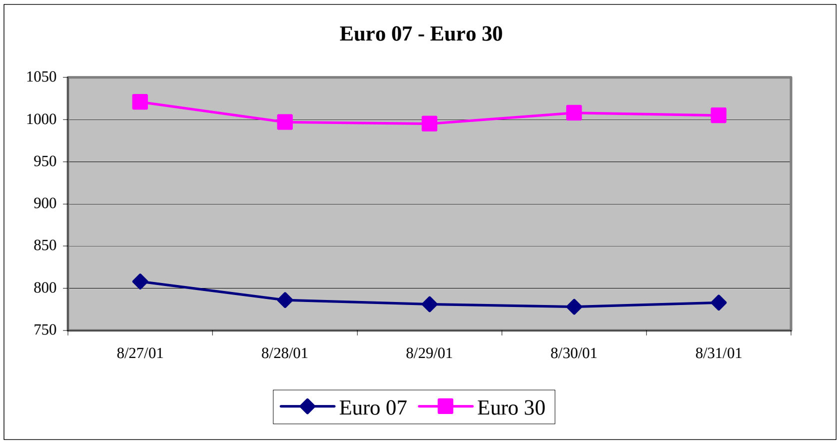




Eurobonds

Russian sector of Eurobonds market recovered completely after July's Argentina crisis and the yields fell all last week. The market still has upward potential - in November Russia is scheduled to redeem its first Eurobond issue which could lead to a ratings upgrade.

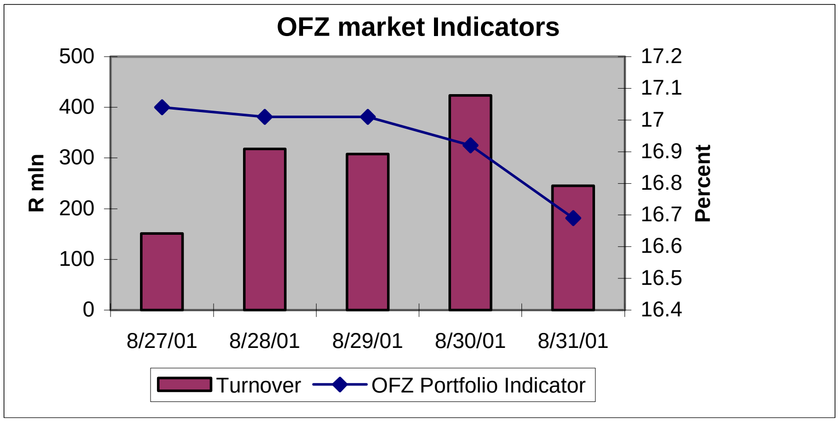




Interest/Bond Market

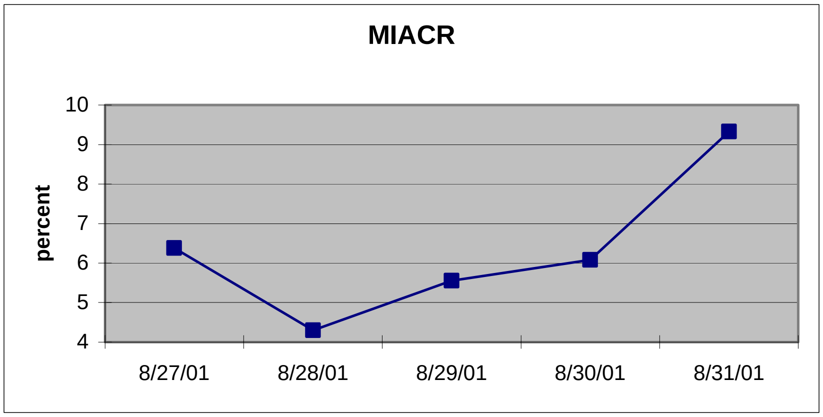
Bonds/Bills

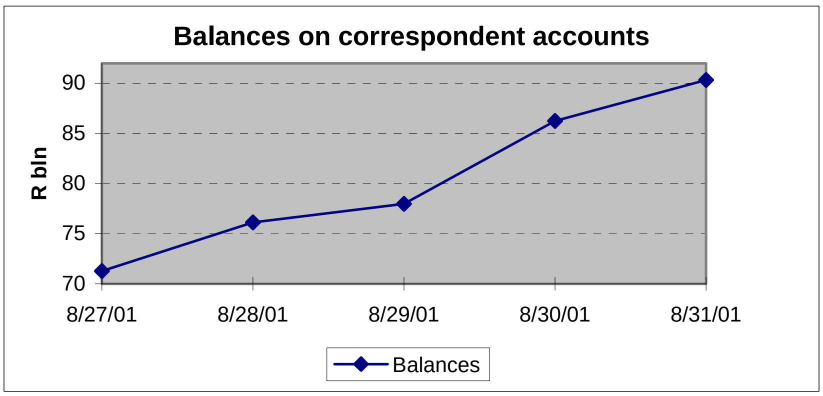
The secondary OFZ/GKO market was quiet last week. Average daily volumes were R289 million, low even by seasonal standards. Trading may pick up in the second half of the month when the Finance Ministry is planning to place R10 billion of GKOs and OFZs.



Overnight rates

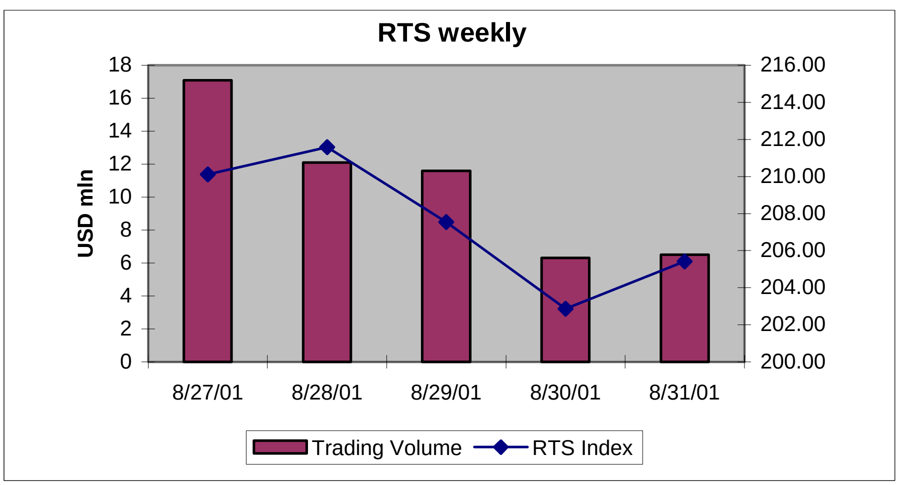
The end-of –month payments caused the balances on the banks' correspondent accounts to increase substantially last week. Rates on the short-term interbank ruble loan market were more or less stable compared to the previous months, when overnight rates were up to 30%.

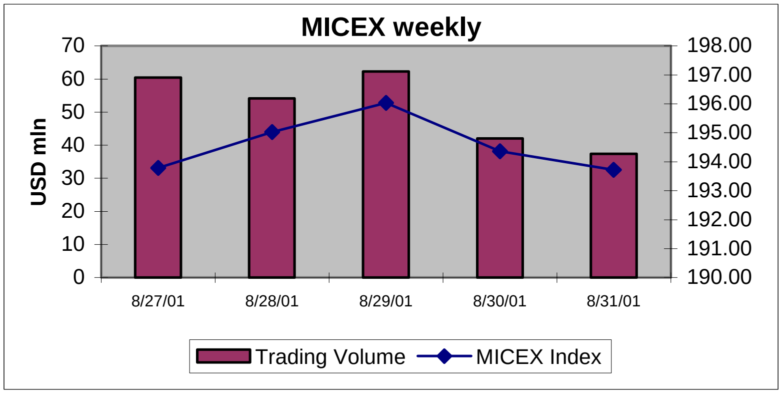


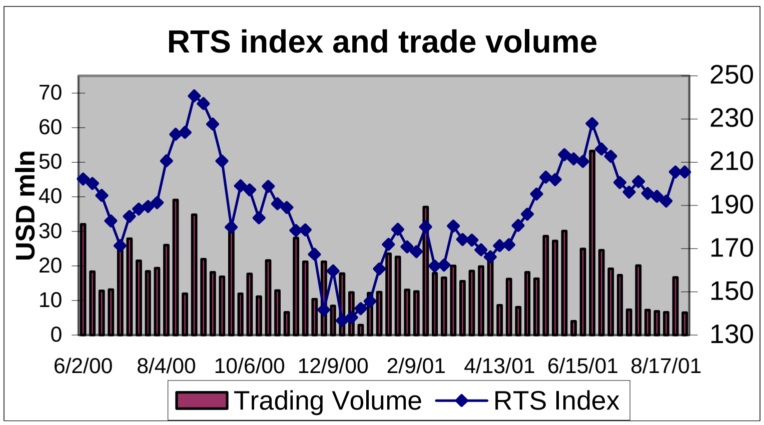


Stock Market

The stock market started the week strongly but then experienced price corrections. Average daily trade volumes were low - $10.7 million. On Friday, the RTS index grew by 1.26% but finished the week down 0.06%.

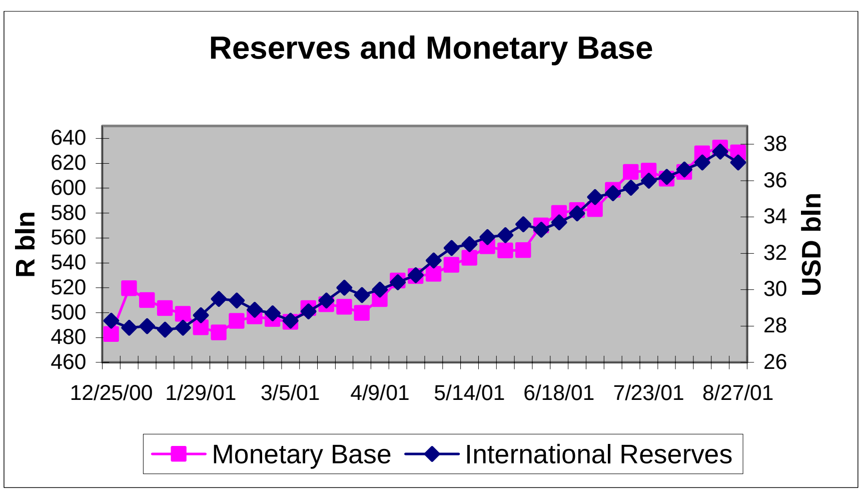






<u>International Reserves and Monetary Base</u>

International reserves dropped $600M Aug.17-24 to $37 billion. As noted this was the result of paying out $1.2 billion to the Paris Club on August 20, not any slowdown in export earnings. Therefore, the CBR actually accumulated around $600 million during last week. The monetary base decreased last week by 0.62% to R628.7 billion.



Weekly Focus: The 2002 Budget - Déjà vu

When the government began to develop its 2002 budget back in July, it appeared that it would be taking a different approach from last year. The GOR's strategy for 2001 was to try to hide money from the Duma by using very conservative economic and oil price assumptions to reduce revenue estimates. This strategy was only partially successful in fending off Duma members who wanted to increase spending in certain areas. It did however have the practical effect of turning the debate into a fight over the formula for dividing "expected" excess revenues, rather than over a more straightforward reallocation of resources within the budget.

The 2002 budget at first glance seems much more realistic and revealing of the GOR priorities. The oil price estimate of $22/Urals is plausible or even aggressive, as is 4.3% growth. The budget runs a 1.2% of GDP surplus that covers a majority of external debt financing, which, unlike in the initial 2001 budget, is assumed to be fully paid. Only inflation of 10-13% may be too low given expected tariff increases and a continuing strong current account surplus. But looks are deceiving. The proposed budget is based on a low 2001 base GDP that does not take into account the government's own recent estimates of growth and inflation. It also may underestimate tax compliance, which so far has responded strongly to lower rates. This means that the 2002 budget probably resembles its predecessor in significantly underestimating revenue.

Duma comments last week seem to signal that they are preparing to do battle as they did last year to squeeze out more spending authority. The difference may be that Putin has had a year to consolidate his control over the Duma and can use the specter of the 2003 debt spike to resist additional spending. In the end it seems likely that the government will be able to push through a budget only marginally looser that what it has proposed. This will leave it with ample flexibility to deal with 2003 debt payments, macroeconomic instability, or out-year structural reform costs.

A fight over assumptions

There are several reasons that that the GOR's 2002 revenue estimates may be too low. The draft budget's 2002 GDP figure of R10,600 billion ($336 billion) is derived from a base 2001 GDP of R8,850 billion. However, 2001 GDP calculated using the latest government growth and inflation estimates (5.5% and 18% respectively) is actually R9,510 billion. Using this more realistic 2001 GDP number as a base for calculating 2002 GDP adds at least R600 billion to the GOR's estimate and another R100 billion ($3 billion) to 2002 revenues. There is also a reasonable chance that the GOR's 10-13% inflation estimate for 2002 will prove too low. The high current account surplus and tariff increases that have caused inflation to run at around 20% for the last two years will likely continue in 2002 and promises of more active sterilization by the CBR have often proved ephemeral (though there have been some good signs recently.) Assuming inflation at 20% rather than 13% would add another R800 billion to nominal GDP in 2002 and another R140 billion to revenues. Finally, there is a possibility that lower rates on the profit tax could significantly boost compliance as they have for the income tax, keeping profit tax revenues from falling as much as the GOR estimates. Taking these factors together, 2002 “excess revenues” begin to look a lot like this year’s estimated excess revenue number of R300-350 billion.

Not surprisingly, Duma leaders, including Budget Committee Chairman Zhukov, have complained that the government is "hiding money" to justify reduced spending levels. While there seems to be acknowledgement that Russia’s tight fiscal stance has been positive for macro stability, large surpluses in the face of domestic needs and structural reforms naturally spawn demands for higher spending. The pressure may intensify when it becomes clear that even in priority areas increases are small and in some cases actually cut spending as a % of GDP. In its explanatory document accompanying the budget submission, the GOR notes increases for military reform (R16 billion), judicial reform (R8 billion), regional subsidies (R60 billion) and social programs (R40B). In the former cases these represent substantial percentage increases but very little money; in the latter cases the increases seem impressive but actually represent zero or negative growth as a % of GDP. In the case of regional subsidies the higher number is particularly deceptive as the region/local budgets’ share of revenues has been reduced from 43.7% in 2001 to 38.8% in the 2002 draft.

How the budget debate plays out will depend somewhat on how the GOR chooses to negotiate. If it gives some on its assumptions prior to the first reading, it may avoid a fight over how to divide excess revenues. If not, it could face a repeat of last year’s debate, which many saw as somewhat chaotic and damaging to an orderly budget process. Assuming some new spending room is opened up, politically powerful lobbies such as the military and security apparatus are likely to demand additional funds and get them. Powerful regions also may be able to limit some of the damage they otherwise face in the budget. Still, given Putin's sway in the Duma, the government should be able to keep most of the revenue windfall.

2003 problem – not a problem

The GOR has justified its tight budget by the need to build reserves to cover 2003 foreign debt costs that are roughly $5 billion higher than the current year. The GOR has toyed with the idea of a stabilization fund, and, while opting not to create something formal, has indicated it wants to build Finance Ministry reserves at the Central Bank to fund out-year expenses. Finance Minister Kudrin has also said that Russia may issue up to $2 billion of eurobonds in 2002, some of which would be held at the CBR to pay 2003 debt obligations or compensate for a change in the external environment (ie. oil prices).

While the 2003 debt problem is real and Russia’s macro outlook does carry risks, the GOR’s public concerns about the problem may be somewhat contrived. In fact, Min Fin has substantial fiscal reserves already: it began the year with around R175 billion ($6 billion) left over from 2000, and has increased these reserves to R247 billion in August. While these may fall again toward the end of the year as spending rises, the current outlook is for reserves to end the year about where they started. As noted above, these reserves should then keep growing in 2002. What’s more, CBR reserves of nearly $40 billion give the GOR a large margin for error if circumstances required it to borrow to finance external debt.

Then why propose to issue eurobonds? With substantial fiscal reserves on hand backed up by large CBR fx reserves, it seems strange that the GOR would want to borrow additional funds (at around 10%) that it doesn't need now or maybe even later, and hold them in the Central Bank (earning 2-3%). One answer is that the eurobond announcement is a fig leaf needed on paper to cover 2002 financing requirements. The GOR draft budget includes financing (primarily the surplus), to cover all but about $1B of scheduled external principal payments. While excess revenues clearly will cover the rest, saying so would open up the debate with the Duma over the GOR's assumptions. Thus the eurobond represents a way to make the numbers work until after the budget is passed.

The other answer is that GOR is not planning to save money for 2003, but instead wants to deal with the 2003 problem now by buying back debt. Market participants estimate that Russia may have already bought back $1-1.5 billion of Min Fins and eurobonds already this year. One sign that this may be the case: as MinFin balances have risen this year, the percentage of balances held in cash has dropped significantly, replaced by reserves held in securities. If Russia does want to buy back more debt next year, either secretly on the market or through a transparent debt exchange, the strategy of issuing new eurobonds begins to make more sense.

A good test of Putin's strength

The fact that this year's budget debate seems to resemble last year's both in terms of numbers and political dynamic makes it a good test of how much Putin has increased his power over the last twelve months. Last year, after a fight, his government was forced to give some on spending but preserved the basic outline of its tight budget. This year the Duma has, if anything, a better case to make that the reins should be loosened somewhat. If the GOR , which is currently talking tough about sticking to its numbers, is able to ram the budget though unchanged, it will be a sign that the Duma has lost it capacity to even modify Kremlin policy on behalf of its constituents. More likely however is that, like last year, compromises will be made on the margins but the GOR will maintain its firm grip on fiscal policy that has been central to Russia's post crisis recovery.

(See budget tables next page)

Budget Tables

Assumptions	2002 Budget (draft)	2001 projected actual (Min Fin)	2001 projected actual (IMF)	2001 Budget	2000actual
Real GDP Growth	4.3%	5.5%	4.0%	4.0%	8.3%
Avg Exchange rate (R/$)	31.5		29.3 (current)	30	28.1
Inflation	10-13(11)%	18	20%	12%	21%
Oil (Urals $/barrel)	22		20.4	18	18
GDP (R Bil)	10600	9510	8500	7750	7630
Estimates					
Expenditures*	1871.9	1379.9	1304	1193.5	855
Interest	289.7	270.3	266	239.8	171
External	231.8	215.1		183.2	
Domestic	57.9	55.2		56.6	
Non-interest	1582.2	1109.6	1038	953.7	684
Revenues*	1998.4	1543.5	1326	1193.5	797
Primary Surplus	416.2		288	239.8	113
Overall surplus	126.5	163.6	22	0	-58
External Debt repayment ($)	14.1		10.4	10.5B	
Interest	7.4		5.9B	6B	
Principal	6.7		4.5B	4.5B	
% of GDP					
Revenues*	18.9%	16.2%	15.6%	15.4%	16.0%
Expenditures*	17.7%	14.5%	15.3%	15.4%	13.7%
non-interest	14.9%	11.7%	12.2%	12.3%	10.8%
interest	2.8%	2.8%	2.8%	2.8%	2.4%
Overall Surplus	1.2%	1.7%	0.3%	0.0%	2.5%
Primary Surplus	3.9%	0.0%	3.4%	3.1%	4.9%

*In 2002 the unified social tax will begin collecting pension fund taxes directly through the tax system. Revenues and expenditures are thus both inflated by R257 billion vs comparable 2001 numbers. If the pension funds are excluded to make the numbers comparable to 2001, total revenues are 16.4% of GDP and expenditures are 15.2% of GDP

Foreign Debt Financing	$ bil	Rubles
Surplus	4.02	126.5
IMF ($ bil)	0	0.0
WB ($ bil)	0.04	1.3
Privatization (R bil)	1.11	35.0
Net domestic borrowing	0.03	0.9
Tied credits	0.685	21.6
Total	5.88	185.3
Other possible financing sources		
Eurobonds ($ bil)	1-2B	32-64
Excess revenues	At least $3B	At least R100B
Total external principal	6.70	211.1
Total external debt service	14.06	442.9

Expenditures (not including R257B collected for pension fund)	% GDP 2002 Budget	% GDP 2001 Budget	%GDP 2000 budget	% change 2002 vs 2001
Defense	2.66	2.77	2.63	-4%
State Security	1.59	1.70	1.49	-7%
Int'l Activity	0.46	0.29	1.05	61%
State Management	0.53	0.53	0.48	1%
R&D	0.27	0.29	0.3	-7%
Industry	0.49	0.58	0.38	-15%
Agriculture	0.17	0.27	0.21	-38%
Education	0.74	0.63	0.6	17%
Culture and Arts	0.10	0.08	0.09	16%
Mass media	0.09	0.08	0.11	11%
Environmental protection	0.09	0.06	0.07	47%
Transport	0.04	0.39	0.03	-90%
Judicial System	0.18	0.15	0.15	17%
Health	0.29	0.29	0.3	1%
Social Policy	1.40	1.39	1.18	1%
Regions	2.30	2.41	1.29	-4%
Debt service	2.73	3.09	4.11	-12%
Other*	1.08	0.41	1.51	164%
Total	15.20	15.40	15.98	-1%

* The increase in "other" expenditures reflects mainly an increase in road construction expenses that was zeroed out in the 2001 budget, and some military reform costs.

Revenues (not including R257B collected for Pension fund)	% of Total 2002 Budget	% of Total 2001 Budget	% of GDP 2002 Budget	% of GDP 2001 Budget
Tax	93.58	93.67	15.37%	15.20%
Profit	11.02	13.25	1.81%	2.15%
Income	0.00	2.55	0.00%	0.41%
VAT	40.99	42.62	6.73%	6.92%
Exise	12.13	15.76	1.99%	2.56%
Customs	18.18	15.65	2.99%	2.54%
Other			0.00%	0.00%
			0.00%	0.00%
Non-tax	5.62	5.17	0.92%	0.84%
Property	2.75	2.07	0.45%	0.34%
Ext Act	2.58	2.60	0.42%	0.42%
Other			0.00%	0.00%
			0.00%	0.00%
Extra-budgetary funds	0.80	1.16	0.13%	0.19%
			0.00%	0.00%
Total	100.00	100.00	16.43%	16.23%

Questions or Comments?

Please send your questions or comments on this Weekly to "ustreasu@online.ru".

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.